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"For this is one of those situations in which optimism is nothing but a form of defection."

Joseph A. Schumpeter
Capitalism, Socialism, and Democracy.
(The last sentence of the book.)

HIGHLIGHTS

Market trends continue to be defined by two themes: the elusive U.S. recovery and the adverse implications of German unification. This letter takes a close look at both.

The Fed's aggressive monetary easing has been highly effective in stimulating financial speculation but utterly ineffective in stimulating the real economy. Money and credit growth, absolutely indispensable for a sustainable recovery, has deteriorated to unprecendented lows.

Excessive government borrowing is holding long-term interest rates at a level that's too high relative to the meagre capital returns obtainable in the real economy. If it weren't so, U.S. long-rates might have been as low as 6-7% rather than the near-8% they are presently.

There's a thick pessimism over inflation in Germany while there is an indomitable optimism on the same in the United States and Britain. We make an in-depth comparison. Germany may have a short-term problem but it's no worse than any of the Anglo countries.

Germany's key problem stems from the insane income policies in east Germany. Pessimism on Germany overlooks two important features: the cumulative reserve of a huge savings surplus and secondly, the self-mending response to the crisis. We explain.

It's critical to realize that the Anglo countries are trapped in a vicious circle of capital consumption in the sense that consumption — public and private — continues to grow relentlessly at the expense of investment and long-term growth potential.

The imbedded slow growth and ballooning budget deficits that result give a strong clue as to how policymakers will react: it makes for a combustible mixture that raises the temptation for debt monetization and inflation over the longer run. And that's bad for the currencies, too.

The great risk for the Anglo countries and their currencies begins when their domestic policies begin to conflict with external requirements. That's when their weakening economies require lower interest rates even while higher rates are required to underpin their currencies.

Long-term world trends remain clear: a group of Anglo countries prone to slow growth, weak currencies and inflationary policies and a strong Europe pegged by a Germany that's already mending from its temporary tryst with large budget deficits.

For investors, that means a continuing concentration in European hard-currency bonds.

THE WORLD AT SECULAR CROSSROADS

With policymakers and most market economists intensely wrapped up in the short-term outlook as usual, many investors, their wealth being at stake, are becoming more and more confused and anguished over longer-term prospects. Will it be economic growth or stagnation, inflation at home and abroad, or fast-spreading deflation? Given the deafening roar of conflicting opinion and professional diagnosis, just what is one to profit from and what should one protect against?

Really, there are no fast and ready answers to these big questions because much of the outcome will ultimately depend on the policy responses of governments and central banks to the new welling problems of the 1990s. Still, we think, in order to properly frame the perspective, it's first critical to fully understand the main underlying long-term trends. Identifying these along with the natural biases of governments, we can make some educated guesses. At any rate, one thing is sure: a combination of long-running secular influences stands to make the world economy and the financial markets of the 1990s very, very different from the 1980s.

THE U.S. LOCOMOTIVE IS LABOURING

Before we venture off to draw a bead on the long-run, let's first review near-term developments: in particular, the U.S. economy which is supposed to lead a world economic recovery. As America's slump may be over, the debate has rightly shifted from the depth and length of the recession to the shape of the recovery. What is being increasingly questioned is its strength and durability. Although many are still expecting a robust recovery, there's been a growing opinion that recovery may be short and shallow.

The first to react to this downward revision in market expectations for the U.S. recovery is the dollar (it has again slipped against the D-mark and the yen) because it has spoiled the key assumption that propelled its rally earlier this year: a progressive rise in U.S. short-term interest rates. As Germany, on the other hand, is condemned to a long period of high interest rates, the interest rate advantage of European currencies against the U.S. dollar is proving to be far more enduring than the markets had expected. With the short-term interest rate differential starkly in favour of the D-mark, being short the German currency has indeed become an expensive and hazardous proposition. We expect that the dollar will yet suffer a substantial decline later in the year.

LITTLE CURRENCY WITH CONSENSUS OPINION

It says something about the collective wisdom of international analysts that the generally predicted convergence of U.S. and German rates has turned into unprecedented divergence. Early last year, when dollar euphoria was first driven by ill-founded U.S. recovery forecasts, the dollar-DM short-term rate gap was still only around 240 basis points. Now, it's around 620 basis points. It certainly begs the question how the dollar should yet manage to move higher despite the Fed's repeated and unexpected easing. Yet, consensus opinion, although less effusive than earlier this year, still expects the dollar to rally.

It's certainly an interesting lesson in market psychology. To be sure, the growing monetary divergence between the two currencies did take its toll on the dollar in the end, causing its sharp fall in the second half of last year. But, most paradoxically, it was the Fed's aggressive full-point cut of the discount rate in December of last year that broke the developing dollar bearishness. Instead of interpreting this drastic action as a symptom of serious economic weakness, the markets took it as evidence of the policymakers' determination to spur the U.S. economy back to life.

From all this we're inclined to draw two conclusions: firstly, never underrate the power of mere expectations to move markets over the short run, even if you regard them as utterly false; and secondly, expectations that are not borne out by the objective facts will nevertheless produce nothing more than short-lived spurts or breaks. Over time, it's the facts that will count.

FLAWED CONSENSUS OPINION

We have many disagreements with the economic consensus. All of these differences find their root in the theoretical approach. Our work and analysis is grounded and determined by the Austrian credit theory, a method above identified all by the names of Mises and Hayek. What baffles us even more than ever these days, though, are the numerous disagreements in the view of facts. How is it possible to disagree about objective facts? We think it's due to sloppy analytical work and wishful thinking.

Take the current global debate on comparative inflation rates. At the moment Germany has a "headline" inflation of 4.5% against 3.2% in the United States and 4.3% in Britain. As many economists do nothing more than extrapolate yesterday's headline into tomorrow's trend, there's now rampant pessimism over Germany's inflation rate even to the point of triggering doubts about the future credibility of the Bundesbank. Meanwhile, there's equally rampant optimism over inflation in the United States and Britain.

In reality, every economist knows that these so-called "headline" inflation rates are distorted by special influences and are therefore ill-suited for comparison. Adjusted for these distortive effects — tax hikes in Germany, volatile food and energy prices in the United States and mortgage interest payments in Britain — the resulting "core" inflation rates look rather different: Germany 3.5%, United States 3.9% and Britain 5.7%.

Assessing these inflation rates, it is moreover essential to take into account the different stages in the business cycle. While Germany is just coming off a boom caused by unification, U.S. and British price pressures must be seen in the context of long-lasting economic weakness. Profits have been devastated, bankruptcies have soared, and corporations have slashed employment in order to contain costs. Seen in this light, the inflation rates in the two Anglo-Saxon countries should really cause more alarm than jubilation.

By no means, though, do we want to belittle Germany's current inflation problem with the above comparison. In Germany, any inflation rate above 2% tends to disturb the social consensus and alarms public opinion. Not only do the Bundesbank and the private economists sound the alarm, but so also does the media. The point of contrast to see is that an inflation rate of between 4-5% causes doom and gloom in Germany and euphoria and self-congratulation in the U.S. and Britain.

COMPARING GLOBAL INFLATION PERFORMANCES

To get a balanced perspective on the inflation question, it's necessary to look at more history than just the last one or two years. Taking 1982-84 as the base for the purpose of comparison, you get the following cumulative rises in consumer prices: Britain 60%, Canada 44%, France 40%, United States 40%, Germany 19%, and Japan 15%. We wouldn't call this a decade of low inflation or even disinflation.

What are the longer-term prospects for inflation? That's the question. In the long run, inflation depends mainly on two things: monetary policy and productivity growth. High productivity growth makes it

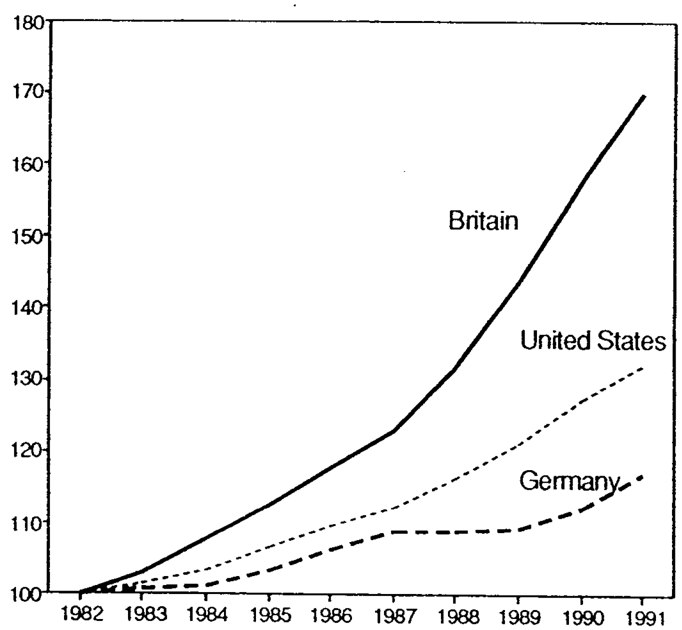
relatively easy to control inflation; low productivity growth makes it very difficult. And, a country's productivity performance, in turn, depends on its long-term savings and investment ratios.

True, Germany's unit labour costs are taking a big jump in 1991-92 now that sharply higher wages are coinciding with a cyclical slowdown in productivity growth. But this is a typical, temporary, cyclical coincidence that ought to be seen from a long-term perspective. Since 1985, Germany has achieved productivity growth of 16% or 2.5% annually, as against an overall wage rise of 31%. Due to additional cuts in working hours, labour unit costs rose 17%. Total consumer price inflation during the period was lower — only 12% or 2% per annum — thus allowing for rises in real wages.

Contrastingly, during this same period America had total productivity growth of 3%, less than one-fifth of the German productivity advance. Concurrently, hourly wage costs rose 30%. The consumer price index was up also 30% and therefore wiped out the entire nominal wage gain. The obvious problem behind the zero gain in U.S. real wages and the high inflation rate is its miserable productivity performance. Without productivity gains, any wage rise is always inflationary.

The graph below illustrates the development of unit labour costs in the United States, Britain and Germany since 1982. Though this period includes the big U.S. recovery in 1983-84, the productivity gap widened dramatically.

COMPARISON OF UNIT LABOUR COSTS
Base year = 1982



MORE INFLATION FALLACIES

Markets are now smitten with the inflation trends they think they see in the future. What should we make of the widespread and alarming perception that German unification has resulted in an over-burdening of the German economy therefore triggering a strong undertow of inflationary pressures which acts as a brake on future GDP growth? And, what credence should we give the other story currently hyping the markets: that U.S. and British manufacturing corporations have been gearing up strong productivity improvements as a result of the broad wave of *"restructuring"* and *"downsizing"*?

The first of these two questions, to be sure, needs a careful and balanced investigation. We want to do that next. As to the second question concerning the U.S.-British productivity "miracle," we can dispatch it quickly. For us, it's just another example of the absurd economics which Wall Street and the City of London are so great at dreaming up.

The key thing to realize is that there's more than one way to improve productivity: either by cutting below-par capacity or upgrading it. As to the restructuring measures in Britain and the U.S — not to mention Canada and Australia and others — the obvious objective of slashing employment costs and lopping off loss-ridden plant is to improve profits over the longer run. Hopefully, those gains will be truly achieved. But what will be the gain for the economy as a whole in terms of higher productive capacity and growth? In short, nothing; it leaves the economy with less productive capacity, less employment and less income. To have a gain for the economy as a whole, businesses would have to expand investment into new, more efficient plant and equipment. Without correspondingly larger investments in the future, all this "downsizing" results in nothing less than general impoverishment.

Unfortunately, new investment is the missing piece in the jigsaw puzzle. Both in the United States and Britain, fixed investment shows a long slide as a proportion of GDP; it has declined to such miserable levels not seen since the 1930s. Interestingly, these developments have had two very different effects in these two countries. In Britain, notorious for wage inflation, it's been largely reflected in high unemployment, while in the United States, more notorious for modest wage rises, largely in falling per capita real wages which are lower now than in the 1970s.

THE MISSING INGREDIENT: INVESTMENT

Few people, it seems, are aware of the lamentable investment trends in the Anglo countries, as compared to their major competitors.

Looking at the adjacent table, two trends are readily apparent: firstly, an accelerating downtrend in the U.S. and British investment ratios; and secondly, a widening investment gap between United States/ Britain and Germany/France, not to mention Japan. If one further takes into account that the U.S.-British investment figures also embrace huge malinvestments in real estate — wasted capital investment in other words — the true situation is even worse than these statistics suggest.

GROSS FIXED CAPITAL FORMATION AT CURRENT PRICES
(As a percentage of GDP)

	U.S.	Britain	Germany	France	Japan
1971-80	18.8	19.1	22.3	23.9	32.7
1981-90	17.4	17.4	20.3	20.3	29.7
1990	16.1	18.6	21.4	20.8	33.9
1991	14.8	15.7	22.2	20.4	34.2

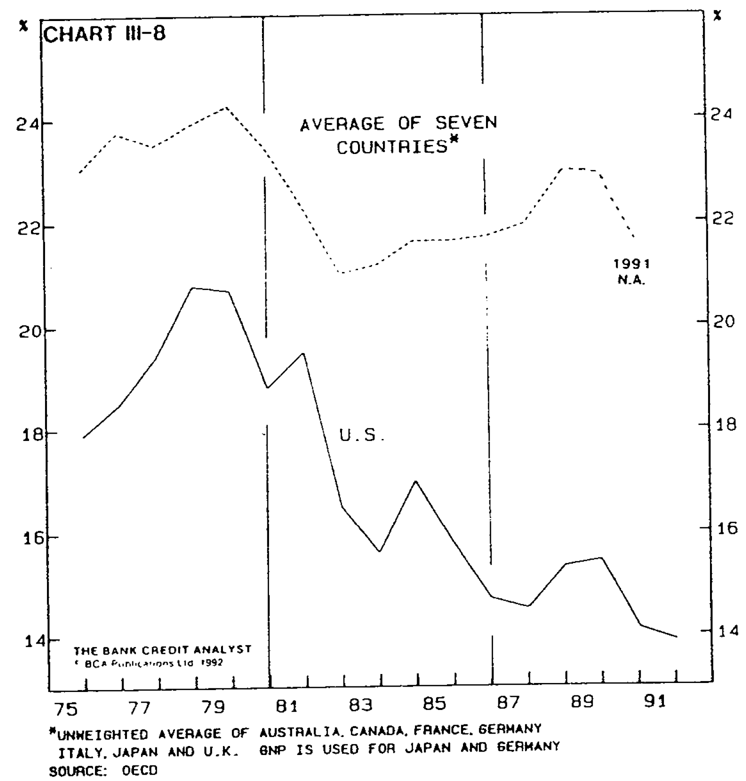
When assessing the economic prospects of the Anglo countries in light of the past credit inflation, the focus of attention is generally on the debt problems and the resulting constraints on businesses and consumers. However, that's only the financial part of the legacy of the 1980s credit excesses. There is another aspect which we already alluded to above that has gone almost completely ignored. It concerns the distortive effects and damages to the supply-side of the "real" economies of these countries which together conspire to erode their long-term growth potential.

All in all, capital formation has been ravaged as never before by overconsumption and vast malinvestment. The damage occurs as resources are pulled away from productive investment for other non-productive uses. Lower growth in the productive capital stock means less capital per worker, which, in turn,

engenders a shortfall in labour productivity or employment and, with it, a stagnation in the standard of living. That's no longer just a prediction. It's already been the reality for years.

What's worse and what should greatly concern the investor is that such a process of economic corrosion does not suddenly come to a halt all by itself. If no remedial action is taken, it becomes cumulative and self-reinforcing. Actually, that's just what we see. America, above all, is trapped in a vicious circle of capital consumption in the sense that consumption — public and private — has grown and continues to grow relentlessly at the expense of investment. Low saving leads to low investment which cramps productivity and growth and swells the budget deficit which, in turn, further reduces the savings available for investment . . . and so on and so on. It may well be doubted that America still has any net saving or net investment left. The graph on this page shows a comparison of the national savings rate of the U.S. versus the average of seven other countries. It's abysmal.

NATIONAL SAVINGS AS A % OF GDP



Source: Bank Credit Analyst, March 1992

As persistent slow growth tends to elicit ballooning budget deficits, the risks of debt monetization and inflation rise over the longer-run. During these confusing times, investors would do well to stay mindful of this temptation.

IMPLICATIONS FOR RECOVERY AND LONG-TERM GROWTH

In our view, the really key question of the 1990s is this: Whether or not the Anglo countries will manage to get out of the quagmire of low savings, low investment, low business profits, and large budget deficits. We have more than serious doubts about that. There is much talk about these structural problems but no serious will to take any action that might cause any short-term pain. The trouble is that the longer such a process of capital consumption has lasted, the more difficult and painful it is to stop it.

For the time being, the big question globally is the near-term U.S. recovery. We are still looking for the evidence of a particular kind of recovery: a genuine one that is self-sustaining and self-reinforcing. So

far, we don't see it. What we see is an upturn that impresses more than it should because many economic statistics are annualized. If U.S. GDP rose at an annual rate of 2.4% in the first quarter of 1992, it's worth recalling that Germany's GDP in the first quarter gained 5.2% on the same basis. The only difference is that the German economists stressed that, in reality, this only represented a non-annualized 1.3% and that the stronger-than-expected result was due to unusually mild weather and two extra working days.

MONEY IS STILL GIVING GRAVE SIGNALS

Scanning for evidence of recovery in the U.S. case, we see not the slightest improvement in the monetary conditions. There is still the same unprecedented gulf between soaring M1 and dormant broad money growth, between an exploding budget deficit and dormant private credit and between hype in the stock market and distress in the real economy.

In past letters, we have always tried to disentangle the underlying relationships at play in this monetary conundrum. As explained, we see a direct relationship between record-low short-term interest rates, soaring M1 and a financial mania. Also, we see a direct relationship between the persistent weakness in broad money, private credit and the real economy. What we have here is an unprecedented, gigantic flight of money out of the real economy into stocks and bonds . . . asset inflation's last hurrah.

Essentially, our assessment remains unchanged: The Fed's aggressive monetary easing has been highly effective in stimulating financial speculation and utterly ineffective in stimulating the real economy into a robust and sustainable recovery.

LOOKING FOR ENGINES OF GROWTH

It's clearly the government's hand that has given the U.S. economy a short-lived push. Surging federal cash and income infusions — rising at a rate of 14% — have temporarily boosted consumer incomes and consumer spending. None of this creates recurrent income growth. Wage and salary incomes have barely kept pace with inflation. While the consumer's hopes may have turned up, consumer incomes and finances show little or no improvement. Talk of a consumer-led U.S. recovery is mere wishful thinking.

Given the weak public and consumer finances, the potential for recovery depends crucially on the health of the business sector. In theory, a recovery could be investment-led and/or export-led. For the time being, however, it's rather hard to see signs of either one.

What most visibly deters us from sharing the common faith in a self-sustaining U.S. recovery is the persistently mournful money and credit picture. Money and credit growth is the absolutely indispensable condition for a genuine recovery. It has never been otherwise. True, the Fed has flooded the banks with reserves, but instead of lending to the private sector, the banks are happily making big, easy money by simply playing the steepening yield curve which favours investment in Treasury paper. Wall Street, in turn, jubilates about rising bank profits as another early indicator of economic recovery and recovering financial health. As a result, virtually, the whole current money creation, which is piling up in M1, stems from bank purchases of government bonds which have little or no correlation with economic activity. M2 and M3, on the other hand, which are more directly related to lending to the private sector, in recent months have again swooned to the weakest growth rates on record.

THE ROOTS OF THE MONEY CONUNDRUM

Symptoms are one thing, causalities are another. The unprecedented dichotomy between narrow and broad money growth has its counterpart in the unprecedented dichotomy between record-high public credit expansion and record-low private credit expansion. Could there be a causal connection between the two? To be sure, there is. It works largely, though not solely, through the interest rate mechanism; the spread between short-term and long-term rates is unprecedentedly wide. Just imagine where U.S. long-term interest rates would be under the present conditions of aggressive monetary ease if there weren't such a gargantuan government budget deficit? Long-rates might have been as low as 6-7% rather than the near-8% as they are presently? Obviously, the sharp falloff in private sector credit growth is failing to produce the normal decline in longer-term rates because it is being hung up by the exploding budget deficit.

Excessive government borrowing, in the last analysis, holds long-term interest rates at a level that's too high relative to the meagre capital returns obtainable in the real economy. The U.S. budget deficit as of April this year, has risen to a record of $405 billion which is equivalent to 7.8% of GNP (Germany' is presently somewhere above 4.5% depending on how one measures it). It's very clear what's happening here: an increasing "crowding out" of private credit by a soaring budget deficit. The counterpart to this squeeze in the real economy (see the table showing the investment ratios on page 5) is a progressive shift in the use of resources from capital accumulation to a squandering on consumption.

Astonishingly, we hear few voices speaking out against this "crowding out". It is indicative of an unwillingness to face the true, hard-core problems that are giving rise to sticky, high long-term interest rates. Rather, unreasonably high inflationary expectations on the part of investors are being blamed as the culprit. The comforting thought with this explanation is that, sooner or later, expectations will correct downward taking long-term interest rates with them. Wall Street loves fairy tales. It'd be nice if it were that easy. Unfortunately, what's needed is either a sharp drop in deficits or a dramatic rise in savings. Both solutions represent some pain for the economy.

THE NEW PANACEA

A new myth has been taken root: the notion that low growth will have tremendously beneficial effects on inflation and interest rates, thus allowing for ever-bullish financial markets. Surely, that's been the usual experience in the past. But, there's a crucial difference between the low growth of the present and that of the past. Before, slow growth was always of a cyclical and temporary nature. This time, it's structural and permanently imbedded. If, for example, the U.S. economy remains stuck with long-term growth of only about 2% annually, we wonder what this will imply over time for budget deficits and monetary policy. Budget deficits are bound to rise even more, thereby putting additional upward pressure on interest rates. What happens then will depend on the policy response of the central banks. If the past is any guide the outcome will be clear. Usually, the central banks have tried to stimulate growth by resisting the interest rate rise. The result? Eventually, a bumper crop of inflation and a weakening currency.

The vital point to see is that for such major countries as the United States and Britain, the long run consequences of short-run policies of avoidance have finally come home to roost. Over time, persistent underinvestment has lead to a permanent decrease in long-run economic growth through the impairing of long-run potential productivity growth. It is an undisputed fact that America's "potential growth rate" has steadily fallen to a low of little over 2%. We have touched on this topic numerous times. It's important because it has far-reaching, long-term implication for policy and inflation.

THE FUTURE IMPACT ON INFLATION

In our view, the unusual experiences of the 1980s have created an unjustified complacency over budget deficits and inflation. Traditionally, it was looming budget deficits that kicked the money printing presses into high gear and ushered in inflation as the central banks tried to avoid the adverse upward influence on interest rates. During the 1980s, the usual inflationary effects failed to emerge largely because of international investors who readily accommodate the fiscal excesses. In fact, since investors so greatly favoured the currencies with the high interest rates, they did what the central banks used to do: namely, artificially reduce interest rates but with the paradoxical result that, due to large capital inflows, the countries with the laxest policies had the strongest currencies. Low-inflation countries, like Germany on the other hand, suffered weak currencies.

This pattern isn't sustainable for very long, and in our opinion, is presently in the throes of reversing. The great risk for all these countries and their currencies starts when domestic and external policy requirements in these countries begin to clash . . . that is when their weakening economies require lower interest rates while higher rates are required to stabilize their currencies.

So far, the currencies of these countries, particularly the dollar, have held up remarkably well despite substantial interest rate cuts. Why is that? Obviously, because foreign exchange traders have been speculating on imminent rises in interest rates, regarding contemporary economic weakness as merely transitory, and have been drawing great comfort from the temporary, recession-induced declines in inflation. The critical point will come when these shallow perceptions changes; when it is realized that weakness is not simply a cyclical symptom but a function of deeper secular erosion.

GERMANY: GOING THE WAY OF THE ANGLOS?

Ironically, the deep concerns that many American and British economists now express about the damaging effects of unification on the west German economy are virtually identical to our concerns about the Anglo economies. The key argument in both cases is that overconsumption associated with large budget deficits is leading to high interest rates which will crowd out private credit demand, particularly for interest-sensitive investment. Eventually, it is held, this will result in lower long-term economic growth. While we have repeatedly spoken of "Amerosclerosis", the medicine is now being returned talking of "Germanosclerosis".

There are, of course, parallels. Only in Germany's case, it's east German overconsumption in the sense that the people there consume far more than they produce. Roughly, they consume at least twice as much as their output. Basically, it is this east German consumption boom that has led to inflationary pressures in west Germany and has forced the Bundesbank to push its interest rates to historic heights. The objective of this policy is to restrict overall German consumption relative to available domestic resources, in that way keeping inflation and large external deficits at bay.

Unification costs are now proving to be a lot higher than expected. The favourite excuse is that the east German economy was found to be in much worse shape than was initially expected. In reality, the cost explosion is more the result of insane income and wage policies in east Germany.

The key economic and financial problems stem from past agreements to equalize east German wages with west German wages by the mid-1990s. While surely raising the cost of unification by retarding the

rebuilding of east Germany, the worst part of this is that a rapid wage convergence automatically implies an east-west convergence in unemployment compensation as well as benefits for pensioners and welfare recipients. As wages and incomes rise out of proportion to east German productivity and production, the bill to fill this widening gap being paid by the west Germans is soaring. In 1991, public transfer payments from west to east amounted to DM 139 billion (5.5% of GDP). This year, these transfers will total to about DM 180 billion (6.5% of GDP). That, in a nutshell, is Germany's current financial and inflation problem. Since 1989 and before unification, west Germany in addition has absorbed 2.5 million east Germans and Eastern Europeans of German origin not to speak of the flood of asylum-seekers. Yet, unemployment fell sharply.

ADDRESSING GERMANY'S PROBLEMS

It's a legitimate question whether or not all these developments are not over-burdening the west German economy and undermining its long-term growth potential. What could happen is that inflation pressures from east Germany — through overconsumption and excessive budget deficits — would require a long period of monetary tightness during which high interest rates would crowd out investment in all of Germany thus lowering long-term growth potential.

We think that the people who paint this picture of "Germanosclerosis" overlook two important differences between Germany and the Anglo countries: firstly, the cumulative reserve of Germany's former huge domestic savings surplus; and secondly, the German response to crisis when it threatens. Yes, there is great alarm in Germany over 4.5% inflation levels and an exploding budget deficit. Ten years ago, when a similar inflation and debt rot occurred under the SPD-party chancellor, Schmidt, he was ousted. It was that wave of protest which brought the present chancellor, Helmut Kohl, into office, and who, indeed, presided over a sharp reduction in the budget deficit.

Kohl got his first warnings in the recent regional elections. There now is a deep discontent with him not only among labourers but broadly across the entire population. Many think he has been spending like a drunken sailor for a plethora of things and causes — the Gulf war, the Russians, the asylum-seekers, and the European Community. And now, to top it off, the government has pledged itself as part of the Maastricht Treaty to sacrifice the D-mark on the alter of European unification and a common currency. This new currency has been scornfully dubbed the "Esperanto currency." In short, Germans are fed up.

In the last analysis, the public uproar is having the healthy effect of forcing the weakened government to institute more fiscal responsibility at home and abroad. That includes the end of the Kohl-Genscher frolic (Genscher was the former foreign affairs minister who recently resigned) of international cheque-book diplomacy. Last, but not least, there is a popular backlash against Europe, partly also due to the shameful behaviour of EC politicians vis-à-vis the Jugoslavian massacres. Seen against this drama, talk about European unity is seen to be hollow and false babble. The next burst of public outrage will be due when the Maastricht Treaty comes up for ratification in German parliament (the Bundestag).

So far, the government has clearly taken the message of budget responsibility to heart. To calm public concern about the deficits and inflation, the finance minister has presented a medium-term fiscal consolidation program that is aimed at a progressive deficit reduction over time. The core plank of the program is a simple regulating device that was successfully applied in the early 1980s: limiting future public spending growth below GNP growth, thus reducing its share of GNP.

The declared objective is to keep the rise in total public spending at 3% per annum (government spending growth is limited to only 2.5%) until 1996. Incidentally, these figures are quoted before inflation. In real terms, public spending growth will be zero or less. The GNP growth assumptions underpinning the tax revenue projections are pegged at 6% before inflation, and as such, look pretty realistic. Assuredly, there is some risk in these assumptions but the thing to remember is that the public is a critical watchdog.

THE WILL TO SELF-MEND

Considering all the black and pessimistic reports about German finances in the international media, we feel compelled to make several remarks. It is, of course, touching to see everyone worry so much about Germany while so selflessly making little of the big problems in their own countries. Again and again we read critical comparisons that reflect German and European pessimism along side imperturbable Anglo optimism. This kind of thinking brings to mind a comment made by Joseph A. Schumpeter near the end of his book Capitalism, Socialism and Democracy where he defends himself against the charge of being too pessimistic about capitalism:

"This finally leads to the charge of 'defeatism.' I deny entirely that this term is applicable to a piece of analysis. Defeatism denotes a certain psychic state that has meaning only in reference to action. Facts in themselves and inferences from them can never be defeatist or the opposite whatever that might be. The report that a given ship is sinking is not defeatist. Only the spirit in which this report is received can be defeatist. The crew can sit down and drink. But it can also rush to the pumps." He ends with the comment we have selected for this issue's headline quotation: *"For this is one of the situations in which optimism is nothing but a form of defection."*

Comparing the German alarm over inflation and government debt with the complacency in other countries, we prefer the alarm. It's the difference between constructive concern and destructive indifference. If a U.S. deficit of almost $400 billion cannot provoke action, then nothing will. That still leaves us with the key question posed earlier: whether or not east German overconsumption could pull the west German economy into the same vicious circle of overconsumption, underinvestment and overindebtedness in which American and the other Anglo countries have become ensnared.

First of all, it should be recognized that corrective action is already under way in Germany. Secondly, the starting conditions for Germany are hardly comparable with those in the United States. The German personal savings ratio is 14% while it's only 5% in the U.S.. Germany's public deficit accounts for about 50% of personal domestic savings while in the U.S. it represents more than 150%. What's happening is that west Germany is shifting its investment toward the east. Total investment in east Germany is officially estimated to rise from DM 72 billion in 1991 to DM 98 billion in 1992. That's equivalent to an investment ratio of 49.5% of GNP versus 37.5% last year, half again as much as the fast-growing economies of Taiwan, Malaysia and southern China.

Given the majority of dollar-bulls around the globe, to be the sure, the exchange markets are understandably only receptive to bad news about Germany; they need it for their long-dollar positions. However, be assured, as we said before: In the longer run, the objective facts finally assert themselves.

CONCLUSIONS

There is little movement in financial and currency markets. The big turbulences only occur when the

established consensus changes abruptly. On that score, if people see the U.S. recovery faltering again, complacency could well turn into desperation. Last year's slowdown may have been seen as an accident; a second one would be a disaster. Clearly, the U.S. stock market and the dollar would suffer most.

For the time being, surging federal deficit spending is buying a temporary boost to the economy. Measured against the massive dosage of monetary and fiscal stimulus, though, the combined impact on the real economy is alarmingly trivial. Only the gullible Dow Jones index is buoying confidence.

As for the dollar, it is set to come under long-term downward pressure as the long-term growth rate of the U.S. economy sharply deteriorates relative to Europe and Japan. This serious loss of dynamism dictates permanently low dollar-interest rates relative to the rest of the world.

Wouldn't that be very bullish for the U.S. bond market? For the short run maybe, but in the longer-run not at all. A worsening budget deficit will tend to exert upward pressure on long-term interest rates.

Fears of a "crowding out" was a bogeyman in the 1980s when foreign money, attracted by high interest rates, saved the day. In the 1990s, foreign capital will no longer be so readily available. Even worse, capital outflows from the U.S. are probable.

Low-growth countries tend to be high-inflation countries because their temptation to over-release the monetary strings is high. Such big increases in inflation as occurred in the 1970s in connection with the oil shocks are improbable, but markets may become rather more unforgiving about 4-5% inflation when the slow-growth scenario sinks in. A falling dollar, crucially, will further crystallize this perception.

As to Germany, we have no doubt that it will tackle the unification and associated deficit problems without damaging its non-inflationary growth potential. Yet, a monetary easing will have to wait. The real policy paralysis is in Washington, not in Bonn.

The more one thinks this all through, the stronger the case — for the U.S. investor particularly — to diversify into the bonds of strong European currencies.

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